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CABINET AFFAIRS STAFFING MEMORANDUM

Date: 2/22/84 Number: 168914CA Due By: _____

Subject: Cabinet Council on Commerce and Trade - February 28, 1984

8:45 a.m. - Roosevelt Room

	Action	FYI		Action	FYI
ALL CABINET MEMBERS	<input type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input checked="" type="checkbox"/>	<input type="checkbox"/>			
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	McFarlane	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Energy	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Education	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input type="checkbox"/>			
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CCCT/Gunn	<input checked="" type="checkbox"/>	<input type="checkbox"/>
GSA	<input type="checkbox"/>	<input type="checkbox"/>	CCEA/Porter	<input type="checkbox"/>	<input type="checkbox"/>
EPA	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/	<input type="checkbox"/>	<input type="checkbox"/>
OPM	<input type="checkbox"/>	<input type="checkbox"/>	CCHR/Simmons	<input type="checkbox"/>	<input type="checkbox"/>
VA	<input type="checkbox"/>	<input type="checkbox"/>	CCLP/Uhlmann	<input type="checkbox"/>	<input type="checkbox"/>
SBA	<input type="checkbox"/>	<input type="checkbox"/>	CCMA/Bledsoe	<input type="checkbox"/>	<input type="checkbox"/>
			CCNRE/	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS:

The Cabinet Council on Commerce and Trade meeting which was scheduled for February 22, 1984, has been rescheduled for Tuesday, February 28, 1984. The meeting will be held at 8:45 a.m. in the Roosevelt Room.

The agenda and background papers are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson
☐ Tom Gibson

☒ Don Clarey
☒ Larry Herbolsheimer
Associate Director
Office of Cabinet Affairs

THE WHITE HOUSE
WASHINGTON

CABINET COUNCIL ON COMMERCE AND TRADE

February 28, 1984

Roosevelt Room

AGENDA

1. Steel Industry Merger and Acquisition Guidelines



THE SECRETARY OF COMMERCE

Washington, D.C. 20230

February 21, 1984

MEMORANDUM FOR MEMBERS OF THE CABINET COUNCIL
ON COMMERCE AND TRADE

FROM: Malcolm Baldrige, Chairman Pro Tempore
Cabinet Council on Commerce and Trade

SUBJECT: The Need for Actions to Enable the U.S.
Steel Industry to Rationalize Itself and
be Competitive in World Markets

Attached is a paper which summarizes the issues raised by the present 200 million ton excess world capacity in steel.

The need for consideration of the subject is triggered by the recent Department of Justice action on the proposed merger of the LTV Corporation and the Republic Steel Corporation.

Attachment

Implication for U.S. Trade and Economic Policy of the Ruling on the Proposed Steel Merger

The United States in a World Market

The effect of an absolute decline in world demand for steel and the intense competition for markets brought on by excess world capacity -- presently more than 200 million tons -- has put tremendous pressure on our domestic steel industry. The pressure is exacerbated by the fact that the U.S. domestic steel market is the largest relatively open market in the world.

There is a need to rationalize the U.S. steel industry and make it more competitive in world markets. United States industry is facing and will continue to face intense competition for markets. The health of our industry and its ability to create new jobs for an expanding work force depends in large part on its ability to compete successfully in world markets.

I am concerned that U.S. firms have not been given enough flexibility to conduct mergers that allow them to respond to increased foreign competition and the changing structure of the world economy.

Imports of Steel Into the United States

The domestic market for steel has been declining for a number of years. The principal cause of the decline stems from the fact that our domestic auto producers have been turning out fewer cars that, on average, are smaller than they used to be and use less steel. But there has also been substantial substitution of aluminum and plastics in products previously made of steel. By 1980, the equivalent of 8.9 million tons of rolled steel production had been replaced by plastic and 6 million tons by aluminum.

While the size of the domestic market has been declining, foreign steel production has captured an increasing share of that shrinking market.

Imports of total basic steel mill products from all countries increased from 16.6 million tons in 1982 to 17.1 million tons in 1983. While imports from the EC countries declined 1.5 million tons (from 5.6 million net tons in 1982 to 4.1 million net tons in 1983), imports from countries other than the EC countries, Canada and Japan increased 2.3 million tons (from 4.0 million tons in 1982 to 6.3 million tons in 1983). While steel capacity of the 24 major industrialized nations who are members of the OECD declined 19 million tons from 1977 to 1983, noncommunist developing country capacity increased 29 million tons and is scheduled to increase another 14 million tons by 1990. Brazil, South Korea, Mexico and the Philippines all have major increases in capacity planned.

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Since 1979, the U.S. steel industry has shutdown 20 million tons, or 13 percent, of capacity. Long-term debt which averaged about \$6 billion in the 70's stood at \$15 billion in 1982. Total employment has decreased by some 156,000 employees in the last three years and the industry has sustained close to \$6 billion in losses over the last four years.

During the 70s and early 80s, most nations in the European Economic Community (EC) -- for political reasons -- continued production of steel Europe no longer needed, in steel plants which were not competitive in world markets. By heavily subsidizing the output of these plants these nations were able to sell in the U.S. market steel for which there was no market in Europe. To end unfair trade practices which had gained the EC substantially increased exports of steel to the United States, domestic companies filed cases under our countervailing duty and antidumping laws.

As part of the agreement that suspended these cases the EC agreed to enforce quantitative limits on various categories of steel that would be shipped to the U.S. Though suffering the highest unemployment rates they have known since World War II, the nations of the European Community have begun a politically difficult program to trim the capacity of their steel industry to the likely demand for the fairly priced products of that industry.

The agreement with the EC is very fragile. Under the terms of the agreement, the undertaking of the EC to enforce quantitative limits on steel shipments to the United States will end in 1985, or at such earlier time as domestic steel companies pursue other actions against the import of steel from the EC nations.

While the EC has not yet done so, it could assert the action of Bethlehem Steel in filing its 201 complaint with the International Trade Commission as justification for refusing to further enforce the quantitative limits it agreed to with the United States.

While the Japanese have, by unilateral action, restrained their shipment of steel into the United States, the internal policies which led the Japanese to take such action could change at any time. There are no bilateral treaties or agreements which restrict the shipment of Japanese steel into the U.S. market.

The agreement with the EC and the unilateral action taken by the Japanese have not resulted in any decrease in the total volume of exports of steel to the United States. Increased production of less developed countries, and aggressive pricing of their products by the steel industries of these countries, have resulted in increased imports from LDC's more than matching reductions in EC shipments and a greater share of the total U.S. market for steel being captured by foreign producers.

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Mergers Can Improve Economic Efficiency and the Competitiveness of United States Firms in World Markets

It is consistent with the policy of this Administration to increase productivity by authorizing mergers that increase efficiency.

Efficiencies brought about by merger may include the following:

- o increasing the production runs of items whose average production costs fall as the cumulative total number of units produced in all periods increases;
- o allowing the after-merger firm to operate more effectively by closing older plants and directing production to newer, more technically advanced plants;
- o increasing the availability and reducing the cost of capital for the after-merger firms;
- o centralizing firms' internal capital used to conduct research and development for new products, or used for productivity improvements in the manufacturing process;
- o centralizing the skilled labor, or "human capital", required to manage the firm, or to conduct specialized research, or to achieve quality production; and finally,
- o increasing the availability of efficiencies in transportation and marketing.

Concentration Risks or Protectionist Risks

The main reason for preventing efficiency-increasing mergers is that they increase concentration, thereby raising the probability of explicit or implicit collusion in setting product prices.

There are three reasons why mergers which increase efficiency should be allowed even if the efficiency gains might eventually be realized by internal expansion.

First, the earlier the efficiency gains are realized, the greater the benefit to society; delaying efficiency gains by insisting that they occur by internal expansions wastes resources.

Second, if foreign firms are allowed to merge to increase efficiency and U.S. firms are prevented from doing so, then the relatively small firms that are driven out of business are most likely to be U.S.-based. In this case measures

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of concentration may fall initially as foreign firms enter the U.S. market. As smaller U.S. firms are driven out of business, however, measures of concentration rise. By preventing U.S. firms from merging, the increase in concentration is postponed and a share of the U.S. market is awarded to foreign firms.

A third reason for allowing such mergers is that if such mergers are not permitted -- particularly in declining, trade affected industries -- foreign competition will lead to increased industry demands for import relief. Trade restraints, if imposed, inevitably lead to domestic price increases and inefficiencies, thereby passing a "protectionist risk" to the consumer, the intended beneficiary of antitrust enforcement. This risk must be balanced against the collusive risk imposed by concentration. The critical question to be addressed with regard to approval of such mergers is which is the greater risk.

We currently face such a "protectionist risk" from the Section 201 case recently held by Bethlehem Steel Corporation, which seeks global quotas limiting U.S. carbon steel imports to 15 percent of the U.S. market as well as legislative proposals to accomplish a similar objective. In theory, protection could provide the industry with capital for modernization -- but at a very high cost to the consuming industries and consumers, who would pay the high price of inefficiently produced steel and reduced competition in the market. And without the pressure of foreign competition, the industry's ability and incentive to become competitive would diminish.

In markets where product demand is growing, protectionist pressures are generally not pronounced. In industries such as steel, which most require effective rationalization by merger, the protectionist risk increases. To deny such industries their principal tool of effective rationalization on the basis that increased market concentration may result in consumer price increases is to greatly increase the risks of such price increases, underwritten by import restraints, without the attendant long-term benefits of rationalization. Import restraints should never be a substitute for rationalization.

This does not suggest that rigorous enforcement of our trade laws and a realistic attitude favoring rationalization by merger are contradictory policies. Effective trade enforcement restricts the flow of subsidized goods, whose prices do not fully reflect the true private costs of production. The resulting trade distortion warrants domestic relief.

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Application of its Merger Guidelines by the Department of Justice Prevents Mergers Which Would Improve the Economic Efficiency and Increased Competitiveness of the After-Merger Firm

The February 15 action of the Justice Department striking down the proposed merger of LTV Corporation and Republic Steel confirmed fears I have expressed earlier to the members of the Cabinet Council on Commerce and Trade. (Please refer to the study paper entitled "Increasing the Efficiency of U.S. Industries to Enhance their Competitiveness in World Markets" circulated by me for consideration at our July 12, 1983 meeting.)

The continued use of domestic market share or concentration ratios as the primary yardstick to measure the competitive impact of mergers and acquisitions has the effect of preventing such mergers even when they would enhance the competitiveness of U.S. firms in the U.S. and other world markets and pose no credible threat to the vitality of competition.

The Justice Department's analysis of the proposed LTV-Republic merger:

- (1) excluded from consideration existing world steel capacity which would very quickly lead to imports that would frustrate any attempted collusive pricing by the after-merger U.S. firms;
- (2) accorded no weight to the value to the United States of the competitor in world steel markets that would be created by the merger;
- (3) accorded no weight to the potential harm to American consumers as a result of the increased likelihood of protectionist actions that may result from its refusal to permit the U.S. steel industry to rationalize itself; and
- (4) accorded no weight to the fact that the automobile industry, which is the market for the flat-rolled steel which would be the principal product of the after-merger firm, is more concentrated and powerful than the after-merger producers of the product would be -- the after-merger firm would not be able to gauge the auto industry.

The Department of Justice decision identified three steel product lines -- hot-rolled carbon sheet, cold-rolled carbon sheet, and stainless sheet strip -- as central to its analysis.

The following table illustrates the substantial increases -- not decreases -- in both import tonnage and import penetration of hot-rolled sheet and cold-rolled sheet. Imports and import penetration for stainless steel sheet and strip are substantial. Though they have been moderated in the last year by temporary relief resulting from a Section 201 investigation which established that our industry had been seriously injured by these imports.

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	Thousand Tons	Import Penetration
<u>Hot-Rolled Carbon Sheet</u>		
1981	2,125	15.1%
1982	1,731	17.1%
1983	2,305	18.0%
<u>Cold-Rolled Carbon Sheet</u>		
1981	1,582	10.4%
1982	1,621	13.3%
1983	2,180	15.5%
<u>Stainless Sheet Strip</u>		
1981	72	9.2%
1982	87	13.5%
1983	84	12.9%

Justice appears to assume that the U.S. steel market is substantially protected against steel imports. In fact, the U.S. steel market is substantially open, and is the largest relatively free steel market in the world. The only quotas in effect, imposed as temporary relief following a specialty steel Section 201 case in 1983, are on stainless bar and rod and alloy tool steel, which together account for well under one-half of one percent of the U.S. steel market.

With respect to carbon steel, the U.S.-EC arrangement was designed not to protect the U.S. market, but to counteract the demonstrated unfair trade by which some of the EC producers increased their U.S. market share in 1982. The arrangement ensures that EC steel remains an important competitor in this market. The arrangement covers only some products, allowing EC producers to shift easily into others. The market shares are flexible for covered products and the market share provisions enable EC exporters to the U.S. to respond to rising U.S. demand. The absence of price provisions enable EC producers to meet or beat the most competitive prices in the U.S. market. The arrangement also provides for substantial liberalization of established limits in cases of short supply.

Although the Justice Department analysis excluded Japan as a competitor in the U.S. market on the ground that Japan voluntarily restrains its steel exports to the U.S., the U.S. has no voluntary restraint agreement with Japan. As prices in the U.S. market

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firm, or as demand warrants, Japanese shipments to the U.S. can be expected to increase; indeed, there are already indications of that trend.

Nor are there any quotas or voluntary restraints on steel from Canada, the LDC producers or any other country. This is particularly significant in that countries such as South Korea, Taiwan and Brazil are important suppliers to the U.S. market -- especially for flat rolled products such as hot and cold rolled sheet -- and are among the most competitive steel producers in the world.

In short, there exists a tremendous amount of steel capacity with which the after-merger firm would have to compete. If the after-merger firm sought to raise its prices above the price at which other producers were willing to sell it would quickly lose its market.

Moreover, there is room for substantial debate as to whether actions short of merger suggested by Justice to the industry as an alternative to merger are in fact feasible.

Plant swapping of major integrated mills is unlikely to occur due to factors such as differences in plant size, degree of modernization, location and product mix. Many firms already engage in intercompany sales or exchanges of raw materials, fuel and semi-finished products on a limited scale. Firms may be opposed to significantly increasing the scope of these transactions, because this would increase a firm's dependence on one or more of its rivals. In weak markets, the rival may seek to cut off its competitor's supplies and increase its own market share; in strong markets the rival may need all of its production to fill its own orders. Firms may also oppose additional intercompany sales or transfers to prevent competing firms from obtaining valuable cost of production information.

Summary

The Administration is deeply committed to allowing free markets to function. Industries, such as steel, that face foreign competition should be allowed to phase out their obsolete facilities and maintain their efficient facilities. Allowing mergers that increase efficiency, will allow these industries to scale themselves down more efficiently.

In the U.S., antitrust authorities have prevented mergers on the basis of arbitrary measures of concentration in narrowly defined product lines. U.S. antitrust authorities have not weighed the benefits of efficiencies permitted by the merger as against the increased risk of collusion.

When the Clayton Act was passed in 1914, and amended in 1950, our national fixation with the need to address the risks of collusive price-fixing in more concentrated markets may have been warranted. In 1950, the U.S. steel industry constituted almost half of western world steel capacity. Today it has less than 18 percent

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of world capacity and imports of foreign steel into domestic markets have grown substantially. In 1984, there is no credible risk -- absent the adoption of protectionist measures to deny foreign steel access to U.S. markets -- that U.S. steel producers can engage in collusive price-fixing.

The risk to America today is that if we don't develop a national consensus favoring making our domestic companies more efficient and competitive in world markets, we will see them gradually wither away.

While there is not at present any credible risk of collusive price-fixing involved in the proposed steel mergers, if a risk existed, it should be assumed as the price of a stronger, more competitive steel industry. The Sherman Act would in any event continue to stand as a bar to price-fixing.

By focusing almost solely on the increased risk of price-fixing, we have made it more difficult to develop a market solution for the very severe steel problems that we have been and will be facing. We have made it more difficult to resist the push for protectionist measures that will guarantee higher steel prices.